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Before the
FEDERAL COMMUNICATIONS COMMISSION
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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 93-215
	)	
Rate Regulation	)	

COMMENTS OF THE NATIONAL CABLE TELEVISION ASSOCIATION

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SUMMARY

The benchmark rates that the Commission has established are inherently imprecise and seriously flawed. As a result, many systems may currently charge rates that are above the benchmark but are nevertheless "reasonable". This proceeding is intended to establish the standards for enabling a system to make that showing based on its costs.

When its benchmark rates were adopted, the Commission explained that to ensure that rates are "reasonable" under the Act, the cost-of-service standards would "embody . . . a balancing of the interests of consumers in paying a reasonable rate and of cable operators in earning a reasonable profit." In its Notice of Proposed Rulemaking, however, the Commission's tentative conclusions strike a very different -- and unreasonable -- balance.

Specifically, a standard that would allow cable operators to recover a reasonable return only on the "original cost" of plant can hardly be expected to enable operators to earn a reasonable profit. And the presumption that all value in excess of the original cost of a system to the seller should be excluded from the rate base because it reflects in some measure an expectation of monopoly profits is entirely unsupportable. In fact, as our comments demonstrate, fully competitive enterprises generally have market values that differ from, and often far exceed, their book values.

Given the transition that operators now face from a free market to a regulated environment, as a matter of fairness, fair market value and full acquisition costs, rather than "original cost", should be used to value cable system investments. Failure to do so will unfairly strain the ability of cable operators to meet their legitimately incurred costs and ultimately will create incentives and cause results that may impair the quality of cable service to the detriment of subscribers.

Furthermore, in establishing a rate of return, the Commission should examine the cost of capital applicable to the system for which rates are being set. The Commission should not ignore the substantial differences in riskiness, both within the cable industry

itself and between the cable industry and other industries, by adopting an industry-wide rate of return based on some other market surrogate.

The Commission, in proposing cost-of-service rules, also must not lose sight of the practical difficulties in implementing fully developed rules at this time. The cable industry has not maintained its books and records in a manner that may easily fit within the cost-of-service mold. Therefore, at this point, operators must have maximum flexibility to present information on their costs in order to justify there rates. There is, moreover, no reason for the Commission to adopt rules prescribing an industry-wide depreciation rate, cost allocations, or a Uniform System of Accounts.

Finally, the Commission should adopt a provision that per channel rates that have not increased faster than inflation since 1986 are "reasonable"-- with no productivity offset. With respect to the other streamlining alternatives, they may well have merit but should not foreclose a cable operator's ability to make a full cost-of-service showing.

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The National Cable Television Association, Inc. ("NCTA"), by its attorneys, hereby submits its comments in response to the Commission's Notice of Proposed Rulemaking in the above-captioned proceeding.

I. INTRODUCTION

Section 3 of the Cable Television Consumer Protection and Competition Act of 1993 (the "Act") established a new framework for the regulation of rates for cable television service. Under that framework, local franchising authorities were empowered to regulate their system's rates for basic cable service (which was to include, at a minimum, any broadcast signals and access channels carried by the systems and was to be provided to all subscribers). Such regulation was to be governed by standards, to be promulgated by the Commission, that ensured that rates were "reasonable."

Rates for optional tiers of "cable programming services" that were offered by systems in addition to the basic tier were not to be regulated by local franchising authorities. But if a franchising authority or subscriber formally complained about such rates, the Commission would be required to review the complaint and to order reductions in any rates found to be "unreasonable." Rates for services offered on a per-channel or per-program basis were not to be regulated in any manner. And systems subject to "effective competition" were not to be subject to any forms of rate regulation.

The Act directed the Commission to promulgate standards for determining whether basic rates were reasonable and whether rates for non-basic tiers were unreasonable, and, on April 1, 1993, the Commission adopted such standards. Although the Act seemed clearly to contemplate two different sets of standards for reviewing basic and non-basic rates, the Commission decided to apply the same standards and the same approach to both levels of service. Specifically, the Commission decided that a system's basic rates should be deemed reasonable if they do not exceed what the system would charge if it were subject to effective competition (which is what the Act requires), and that non-basic rates would be deemed unreasonable if they do exceed what would be charged by comparable systems subject to effective competition (which is much more stringent than what the Act requires).[1] And, to implement this standard, the Commission adopted a "benchmark" approach, based on a complicated analysis of the average rates charged by systems that are and are not subject to effective competition. Under this approach, any rates that exceeded benchmark levels could be rolled back to those levels (or to 10 percent below what the system charged, on a per-channel basis, on September 30, 1992, whichever is the lesser reduction).

The Commission recognized that its benchmarks were imperfect approximations of what systems would charge if they were subject to effective competition and that, in some cases, a system's "reasonable" rate might be considerably higher than what its benchmarks allowed. Indeed, given the methodology for calculating the benchmarks, this is likely to be true in a large number of cases. The benchmarks represent the average

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1 We have discussed at considerable length, in our Petition for Reconsideration of the Commission's decision, why this approach is at odds with the language of the Act, its legislative history and congressional intent.

rates charged by all systems with similar characteristics,[2] reduced by an amount (10%) that is supposed to reflect the average difference between rates charged by systems that are subject to effective competition and those that are not. For many systems, these average benchmarks will clearly miss the mark.

First, since systems face a range of costs, there is obviously a range of rates that are reasonable and competitive. Systems with costs that are above the average will charge rates that are above the average, whether or not such systems are subject to effective competition. Indeed, half the systems subject to effective competition charge rates that are above the average -- yet, by definition, those systems' rates are competitive and "reasonable." To the extent that the Commission's benchmarks are based on average rates, systems with above-average costs are likely to charge rates that exceed the benchmarks, even though those rates are wholly justified.

Second, the 10 percent reduction in average system rates is based on the erroneous assumption that there is a uniform, across-the-board 10 percent difference between rates of competitive and non-competitive systems. As we showed in our Petition for Reconsideration, there is no such uniform difference. In fact, for systems with more than 5,000 subscribers, there is no significant difference at all between rates of competitive and non-competitive systems. Therefore, the benchmarks' 10 percent reduction in average rates would force systems with more than 5,000 subscribers to charge 10 percent less than what the average competitive system charges.

For these reasons, many systems may charge rates that are above the benchmarks but are nevertheless "reasonable," insofar as they do not exceed what would be charged if the system were subject to effective competition. Because the Act requires that the

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2 The relevant characteristics are (1) number of subscribers; (2) number of channels; and (3) number of satellite services provided.

Commission's rules and standards ensure that rates are reasonable, the Commission properly recognized that systems must have an opportunity to show that rates in excess of their relevant benchmarks are, nevertheless, justified and reasonable in light of their particular circumstances. This proceeding is intended to establish the procedural and substantive standards for making such a showing.

In its Report and Order, the Commission properly described what its objective, in crafting such standards, should -- and should not -- be. The Commission specifically rejected the notion that its task was to allow rates in excess of benchmarks only where the benchmark rates would be "confiscatory" under the Fifth Amendment. To ensure that rates are "reasonable" under the Act, the cost-of-service standards are to

> embody . . . a balancing of the interests of consumers in paying a reasonable rate and of cable operators in earning a reasonable profit. A "confiscatory only" standard would, by contrast, constitute a substantially stricter standard that may ultimately disserve consumers by limiting cable operators' business incentives to provide service.[3]

Thus, the Commission seemed, in its Report and Order, to understand that its benchmarks were inherently imprecise and that any presumption that benchmarks represent reasonable rates should be rebuttable, on a case-by-case basis, through cost-of-service showings. In the Notice of Proposed Rulemaking, the Commission pays lip service to these same principles and objectives. But it proposes a cost-of-service model that strikes a very different balance. Specifically, a standard that allows cable operators to recover a reasonable return only on the "original cost" of plant and not on the capital actually invested in the system by its present operator can hardly be expected to permit rates above confiscatory levels in all cases and will, in fact, result in confiscatory rates. Moreover, a model that is based on original cost and that disallows recovery of a

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[3] Report and Order, ¶ 263 (emphasis added).

reasonable return on the full market value of a cable system will have precisely the adverse effects on cable operators' incentives and on consumer welfare that the Commission sought to avoid.

The Notice's tentative conclusions regarding rate base, rate of return and depreciation appears designed to yield rates so low as virtually to ensure that operators accept benchmarks and avoid cost of service showings. It is understandable that the Commission will, in light of limited resources, try to limit the situations in which cable systems opt for cost-of-service proceedings. But basic fairness -- and principles of due process -- counsel against procedures intended to deter operators in individual cases from employing the only process through which they can obtain just compensation.

The right way to encourage reliance on benchmarks and to discourage operators from resorting to cost-of-service proceedings is to ensure that the benchmarks, in most cases, provide operators with rates for basic and non-basic tiers that are sufficient, overall, to cover their costs plus a reasonable profit. The current benchmarks, for reasons described in NCTA's Petition for Reconsideration, are severely flawed and do not achieve this objective.[4] To encourage reliance on benchmarks, the Commission should, therefore, fix those flaws; it should not seek to force operators to price at unreasonably low benchmark rates by adopting cost-of-service rules that yield even more draconian results.

No benchmarks, of course, can be expected to yield perfect results in all cases. Even if the flaws in the existing benchmarks are corrected by the Commission, some systems will still need to demonstrate that their rates, though in excess of their benchmarks, are reasonable. And to avoid the need for expensive cost-of-service proceedings, the Notice presents several proposals for alternative "streamlined" showings. To the extent that "streamlining", however, is "based on average costs of providing cable

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4 NCTA Petition for Reconsideration, MM Docket No. 92-266 (filed June 21, 1993).

service based on the costs experienced by all systems, or of similar systems,"[5] it would not be workable without much more information than currently exists about the general costs of operating cable systems. If streamlining turns out to be based upon broad industry averages and over-generalizations, it will be no more reliable than the benchmarks in particular cases and will not serve the purpose of cost-of-service showings, which is to allow individual systems to show that, notwithstanding benchmarks based on industry averages, their rates are reasonable.

For now, there is no way to accomplish this objective except to afford cable operators maximum flexibility to demonstrate the reasonableness of their rates. This will require, for the time being, a system under which operators are allowed to maintain their own costing and accounting methodologies, so that they may present, in cost-of-service proceedings, all available evidence that is useful to justify existing rates. And it will require standards that allow franchising authorities and the Commission to authorize rates that exceed confiscatory levels but are reasonable in light of the costs of the system and in light of Congress's intention to provide operators with incentives "to continue to expand, where economically justified, their capacity and the programs offered over their systems."[6]

II. ELEMENTS OF THE RATE BASE

A constitutionally acceptable approach to cable television ratemaking involves a "balancing of investor and consumer interests".[7] The fact that individual elements of a ratemaking methodology viewed in isolation may have been found not to produce, in

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5 Id. ¶ 74.

6 Act, § 2(b)(3).

7 Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944) (hereinafter "Hope").

particular cases, confiscatory rates does not validate the "end result" of a rate order. As the Supreme Court has instructed, "it is not theory but the impact of the rate order which counts."[8] The end result itself may be unlawful where the rate established reflects an unfair and unreasonable balancing of interests.[9]

The Commission's approach, as reflected in its tentative conclusions on valuation of the rate base, may unreasonably tip that balance. Fashioning a cost of service methodology based on "original cost" that is unreasonably focused on deriving the lowest rates for consumers increases the risk that the ultimate end result will be an unreasonable rate.

A. Valuation of Plant in Service

The Notice proposes to adopt an "original cost" methodology to determine the value of a cable operator's plant in service for rate base purposes and to exclude from the rate base "excess" acquisition costs.[10] This draconian approach stems from the Commission's assumptions that costs arising from system acquisitions at prices above the original cost to the seller are attributable, to some unspecified degree, to an "expectation of monopoly earnings"[11] and that exclusion of such excess acquisition costs will ultimately promote consumer welfare. These assumptions are wholly unsupportable for a number of reasons -- and, in any event, such a post hoc decision to deny cable operators

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8 Id. at 602.

9 See Permian Basin Area Rate Cases, 390 U.S. 747, 800 (1968) (in examining the end result of a rte order, it must be the case that the component decisions of that order "[d]o not together produce arbitrary or unreasonable consequences."); Jersey Cent. Power & Light Co. v. FERC, 810 F.2d 1168, 1177 (D.C. Cir. 1987).

10 NPRM at ¶ 35.

11 Id. at ¶ 21.

an opportunity to recover a reasonable profit on the full market value of their investments would be fundamentally unfair, confiscatory, and contrary to sound policy.

1. Market Value in Excess of "Original Cost" Does Not Constitute Expectations of Monopoly Earnings

First of all, there is simply no basis for assuming that all value in excess of original cost represents, in whole or in part, capitalized monopoly profits.[12] As the attached study prepared for NCTA by Economists Incorporated demonstrates, fully competitive enterprises generally have market values that differ from, and often far exceed, their book values.[13] Market value may differ from book value for reasons having nothing to do with monopoly earnings. These include inflation, divergence between real and accounting rates of depreciation, and various intangible assets, such as goodwill, customer lists, and superior skills and abilities that lead to expectations of higher earnings.

The Commission acknowledges that there are a variety of reasons why the market value of a system may exceed original cost. Primary among them is the notion that "customers may benefit from the sale if the purchaser is able to realize operating efficiencies unobtainable by the seller. In competitive markets, premiums over original cost are presumably noted in potential operating efficiencies."[14] The Commission goes on to state that "in non-competitive markets, however, premiums may, at least in part, be

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[12] In fact, the Notice itself contradicts this proposition, recognizing that "while a comparatively high acquisition cost may reflect the expectation of monopoly profits, it may also be consistent with the estimation of market value (measured by multiples of cash flow) or similar businesses (e.g., broadcast stations) subject to transactions during the same period." NPRM, ¶ 36 n.40.

[13] Appendix A.

[14] Notice of Proposed Rulemaking, 8 FCC Rcd. at 548 (1993).

predicated on the expectation that customers have no alternative to paying a rate for service that includes a monopoly rent component."[15] But there is no evidence that this is the case in a particular instance, particularly where the service lacks the traditional indicia of an essential facility.[16] The service provided by cable operators -- television programming -- lacks the element of necessity found in the goods or services provided by traditional regulated monopolies like electricity, natural gas, water or telephone services. Even for the service provided, there are always competitive alternatives such as broadcast signals. And in the rapidly evolving technology of this industry, potential competition from other sources must certainly have constrained any expectations of monopoly profits in system acquisition transactions.

Indeed, the Commission's own data regarding cable system rates refutes the notion that cable rates generally include monopoly profits. As described above, an analysis of the FCC's sample from which the benchmark rates were derived[17] shows that for systems serving 5,000 or more subscribers, there is <u>no difference between rates charged by "competitive" and "non-competitive" cable systems</u>. If anything, then, it could be presumed that those systems are charging no more than their costs plus a reasonable profit -- and certainly not a level reflecting an expectation of monopoly rents. An across-the-

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15 <u>Id</u>.

16 NCTA argued that the Commission should distinguish in its benchmark approach between basic and upper tier rates. If any part of the cable operator's service has attributes of an essential facility, it is basic service comprised of the local broadcast signals and access channels. But by its unitary approach, the FCC's benchmark approach eliminates the utility of an essential facilities analysis here, and whatever significance it would have to cost of service standards.

17 Economists Incorporated, <u>The Effect of "Competition" on Rates Differs for Large and Small Cable Systems</u> (submitted as an attachment to NCTA's Petition of Reconsideration in MM Docket No. 92-266, filed June 21, 1993).

board assumption that market values and acquisition prices of cable systems reflect capitalized monopoly rents, therefore, is simply unwarranted. Before any disallowance of acquisition costs incurred prior to the imposition of regulation can be justified, the Commission must have a specific record basis for concluding that disallowed costs represent monopoly profits. No such basis exists.

2. Cable Operators Should Be Allowed to Include Their Full Market Value and Acquisition Costs in the Rate Base as a Transition to a Regulated Environment

While the Commission claims that excluding "excess" acquisition costs and intangible assets from the rate base would best balance the interests of consumers and investors, in fact it produces an end result that is unreasonable, unbalanced and unconstitutional. As a matter of fairness, these legitimate costs should be allowed as part of a transition from an unregulated to a regulated environment.

The Notice supports exclusion of excess acquisition costs and intangible assets from the rate base based on the "traditional practice in rate regulation."[18] There are both practical and policy reasons for this traditional practice regarding ongoing regulation of utilities -- neither of which apply in these circumstances.

As a practical matter, a primary virtue of "original cost" in ratemaking was the belief that it was a more easily verifiable valuation method.[19] But this rationale is simply inapplicable to the cable industry, which has never before been subject to rate base regulation. The current owner of an acquired system most likely does not have records demonstrating what the "original cost" of a particular property would have been to the seller (who in turn might not originally have built the system). But even if that

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18 Notice, ¶ 38.

19 See Duquesne Light Co. v. Barasch, 488 U.S. 299, 309 n.6 (1989).

information is available in some cases, it may well not reflect any consistent determination of value across the cable industry. There is no Uniform System of Accounts. Accounting methodologies have been adopted based on tax and financial reporting, rather than regulatory, reasons. Accordingly, no attempt has been made to create a record of "invested capital" to be included in the rate base.

Use of original cost valuation also distorts the rate base for systems that have not been acquired in that it fails to take into account operating losses for years prior to rate regulation and to provide for recovery of returns forgone. Many operators incurred substantial losses in developing their systems, with the expectation that these losses would be recovered in future years. The Notice recognizes that "large financial losses are common across the industry and that write-offs of various organizational and development costs, and accelerated depreciation practices, appear to be at least partly responsible for accumulation of those losses. It may be reasonable to view such accumulated losses as capital invested with an expectation of recovery over future periods as the industry reaches maturity." Notice, ¶ 39 n.44. If the Commission fails to adopt full market value as the proper measure of the rate base, then it surely must allow inclusion of operating losses in the rate base.

Moreover, one of the other policy bases for the general rule simply does not exist in cases where an industry is moving from an unregulated to a regulated status. As Judge Goodwin has explained,

> Economists have found that, because utilities are allowed a return only on their rate base, they have developed an "edifice complex," padding their rate bases. See, e.g., Averch & Johnson, Behavior of the Firm Under Regulatory Constraint, 52 Amer. Econ. Rev. 1052 (1962). Fear of utilities inflating the rate base led to the per se original-cost rule in intra-industry sales.[20]

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[20] Montana Power Co. v. FERC, 599 F.2d 295, 303-04 (9th Cir. 1979) (Goodwin, J., dissenting) (emphasis added).

But operators obviously did not incur excess acquisition costs or pay artificially to inflate their rate base.[21] To the contrary, these costs were incurred at arms' length[22] when there was no expectation that cable operators would be rate regulated at all, much less regulated under a cost-of-service model. Moreover, while cable systems had none of the perverse incentives from regulation that gave rise to the use of original cost in traditional utility ratemaking, their acquisitions were generally subject to regulatory approval by local franchising authorities. To the extent that such approval was required, there is no basis for assuming that the acquisitions -- or the prices paid -- were in any way "imprudent".

It is precisely because of a concern about the perverse incentives of regulation that the cost of plant acquired by a regulated entity but originally constructed by others is generally calculated as the value of the plant when it is first "placed into service" for regulatory purposes.[23] Unlike a utility, whose assets are added to the rate base

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21 Compare Montana Power Co. v. FERC, 599 F.2d 295, 300 (9th Cir. 1979) ("The original cost method has been applied to property acquisitions by utilities to prevent utilities from artificially inflating their rate base by acquiring properties at unrealistically high prices.")

22 Compare AT&T v. U.S., 299 U.S. 232, 239 (1936) (court upholds original cost valuation in part based on concern that purchases were not arms length "and price agreed upon may be a poor criterion of value. . . .[E]ven if the property had been acquired by treaty with an independent utility or a member of a rival system, there is always a possibility that it is nuisance value only -- and not market or intrinsic value for the uses of the business -- that has dictated the price paid") with Decision on Remand, 7 FCC Rcd. 296, 299 (1991) (Commission reverses its decision to presumptively exclude plant acquisition adjustment from the rate base where carrier purchases plant without traffic from a non-affiliated carrier; "When the price of an asset is determined by an arm's length transaction in the normal course of business, we believe there is reasonable assurances that the price paid would not be manipulated to the detriment of rate payers. We see no incentive for a carrier to inflate the rate base in such situations.")

23 See Tennessee Gas Pipeline Co., 15 FERC ¶61, 100 (1981) (original cost is purchase price paid by regulated utility); Virginia Electric Power Co., 38 FPC 487 (1967) (full acquisition price included in rate base where utility purchased transmission line from

(incrementally and often with the prior approval of the rate-making authority) after regulation begins, current cable operator assets are entering the rate base all at once. There is no reason not to value those assets, at the outset, at their market value at that time.

If costs that have already been incurred are automatically excluded from the rate base, many operators may be unable to service their debt and will not be financially viable. That this result is contrary to the Constitution is beyond doubt. As the Supreme Court has made clear,

> The ratemaking process... involves a balancing of the investor and consumer interests .... [T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view, it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock.[24]

The Commission cannot choose to simply turn a blind eye to the effects of this across-the-board disallowance on the financial integrity of individual companies. Merely because "original cost" has been accepted as a ratemaking methodology in other contexts does not make it appropriate or lawful[25] here, where the industry is in the process of making a transition from an unregulated to a regulated environment. Indeed, the Commission in the past has allowed valuation other than original cost for acquisitions as

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federal government); Black Hills Power & Light Co., 40 FPC 166 (1968) (utility purchase of transmission line from private oil company included in rate base). See generally Bonbright, Principles of Public Utility Rates 237 (2d ed. 1988) ("original cost" means cost of asset when first devoted to public service rather than cost to transferee company).

24 Hope, 320 U.S. at 602 (emphasis added).

25 See generally Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168 1180 (D.C. Cir. 1987) ("The fact that a particular ratemaking standard is generally permissible does not per se legitimate the end result of the rate order it produces.")

a transition mechanism. For example, in LEC Rate Base, the FCC applied its rules regarding acquisition adjustments only prospectively, and grandfathered existing acquisition adjustments within the rate base.[26] At the very least, a similar transition mechanism is necessary here.

Not only is there no reason to value cable systems at anything less than their full market value at the time of initial regulation. Failure to do so will also unfairly strain the ability of cable operators to meet their legitimately incurred costs and will, ultimately, create incentives and cause results that impair the quality of cable service to the detriment of consumers.

The Notice appears to assume that this disallowance will benefit consumers because it will produce the lowest possible rates.[27] But focusing only on rates ignores the consumer interest in the product itself -- which is much more variable than the product in typical utility ratemaking. That product, of course, is video programming. Unlike essential utility products like water, natural gas and voice communications, the quality and the quantity of programming provided by cable systems can vary substantially. And regulatory decisions regarding what is and is not to be included in a cable system's rate base can substantially affect the quality and quantity of the system's product.[28]

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[26] Order on Reconsideration, 4 FCC Rcd. 1697, 1705 (1989).

[27] Notice ¶ 35.

[28] The Notice tentatively concludes that "programming expense would be a recoverable operating expense, but would not be a cost element for inclusion in rate base." Notice, ¶ 24 n.24. In soliciting comments on whether operators nonetheless should be allowed a profit on programming expense, the Notice implicitly recognizes the adverse effects on programming incentives that ordinarily would flow from a traditional cost-of-service regulatory scheme.

Such a scheme takes into account investments in facilities, but not investments in programming. As a result, it distorts incentives to invest in items, like programming, that are not capital intensive. (footnote cont')

First, if systems are not allowed to recover their fixed debt service, they may be forced to reduce expenditures on variable costs such as programming costs. Forcing cable operators to alter the nature of the product that they provide -- to provide a different product at a lower price -- does not benefit consumers. The experience of the cable television industry from post-1986 deregulation to the present shows that consumers value increased program quality, even in the face of rate increases. During that period, cable industry programming investments and cable rates increased more rapidly than before -- but so did cable penetration.

Excluding intangible assets and excess acquisition costs from a cable operator's rate base will also create future investment incentives that adversely affect quality of service and disserve consumers. Specifically, systems will have reduced incentives to maximize the quality and capabilities of their existing facilities by investing in ways that increase goodwill and customer satisfaction. After systems have been denied a reasonable profit on their past investment in such intangibles, "[t]he result next time will be the scrapping of a perfectly good transmission line and the construction of a new one for double or triple the cost."[29]

Excluding past investments in excess acquisition costs and intangibles from the rate base will not, of course, deny consumers the benefits of those past investments. In other words, one way to reduce rates and to ensure high quality service would be to encourage cable systems to make investments based on certain assumptions regarding risks and anticipated future cash flows, and then, after the investments are already made, to change the rules and deny systems their anticipated returns. Systems would not have

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In order to offset these incentives, and to increase the diversity and amount of programming available to subscribers to regulated tiers, operators should be allowed to earn a profit on programming services.

29 Montana Power Co., supra, at 303 (Goodwin, J., dissenting).

invested in intangible assets had they known they would be denied a reasonable return on such investments -- but if the government waits until after the investments are made to deny a return on them, then consumers can have their cake and eat it too. The investments have been made, but consumers don't have to pay for them.

In the short term, such a post hoc reduction in a system's value constitutes the most fundamentally unfair taking of property. And in the long term, it weakens the underpinnings of property rights in a way that will curtail investments that consumers would desire. If retroactive disallowance by the government of a reasonable return on certain investments is permitted, then the prospect of such governmental action in the future will add significantly to the risk of such investments in the future.[30]

In sum, excluding excess acquisition costs and intangible assets from a cable operator's rate base -- i.e., calculating the rate base on the basis of original cost rather than full market value -- would unfairly deprive cable operators of the value of their property by denying them profits that are commensurate with the risks they took, the investments they made, and the success that they had in making more efficient use of their capital assets. And, while yielding lower rates, it would result in cutbacks in expenditures and in future investments that would diminish the attractiveness of cable service to consumers.

In these circumstances, reliance on original cost would not only be bad policy but may go beyond what the Constitution permits -- notwithstanding its use in other ratemaking contexts. In assessing the constitutionality and appropriateness of ratemaking approaches, as the Supreme Court has made clear, "it is not the theory but the impact of the rate order which counts."[31] In these unique circumstances, where there is a transition

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30 See Appendix A at 6 ("The possibility of another levy of this type increases investors' uncertainty about investment returns, leading them to apply a higher threshold rate of return to future investment projects. Therefore, projects that would have been under taken will be foregone, hurting both cable operators and consumers.")

31 Hope, 320 U.S. at 602 (emphasis added).

the rate order which counts."[31] In these unique circumstances, where there is a transition from a free market to regulation and where the product at issue is non-essential and subject to variations in quantity and quality, original cost valuation will, on balance, have a profoundly negative impact not only on cable operators and investors but also on consumers. Its impact would be at odds with what is contemplated by the Act. It should be rejected, and an approach that includes full market value and full acquisition costs in the rate base should be adopted.

B. Other Elements of the Rate Base

1. Working Capital Allowance

The Commission proposes to permit cable operators to include net working capital in their rate base.[32] This is an appropriate result. However, as the Notice recognizes, an analysis of the "leads and lags" associated with payments to determine the proper cash working capital allowance would be "an arduous task for most companies"[33] and should not be required in all cases. Nevertheless, the Commission should permit a cable system to demonstrate, through lead-lag studies or other methods, where possible, to demonstrate the proper allowance for investor supplied working capital.

2. Plant Under Construction

The Commission proposes that plant under construction be withheld from the rate base until the plant is placed in service, but that interest during construction be capitalized.[34] The Commission thus properly recognizes that the cost of capital incurred

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31 Hope, 320 U.S. at 602 (emphasis added).

32 Notice, ¶ 44.

33 Id.

34 Notice, ¶ 42.

during the period required for plant construction is a legitimate cost of doing business and should be recovered. There are, however, several valid methods for recovering the capital cost associated with construction work in progress.[35] The FCC should not automatically postpone recovery of capital costs for construction work in progress until the construction is completed. This treatment could adversely affect the financial integrity of an individual company. And if the Commission disallows rate base recognition of the capital investment in construction, the full carrying cost of that capital must be recovered. Use of interest during construction only may not achieve that result. Accordingly, the Commission should not, without further study, choose one treatment over the other.

3. Excess Capacity, Cost Overruns and Premature Abandonment

The Notice seeks comment on whether costs incurred by a cable operator that represent excess capacity, cost overruns and premature abandonment should be excluded from the rate base.[36] Blanket disallowances of plant investment on these grounds are not warranted. The Commission should make clear that all prudently incurred plant investment should be granted rate base recognition. A contrary rule, which would subject prudently made investments to possible disallowance because subsequent changes in circumstances affect their usefulness, would impose a level of risk on investors that is inconsistent with returns normally allowed under regulation. If the Commission excludes these costs from the rate base, then, it must grant investors a higher return on account of this increased risk.

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[35] See generally Communications Satellite Corp. v. FCC, 611 F.2d 883, 895 (D.C. Cir. 1977) (discussing alternative methods to take account of plant under construction).

[36] Id., ¶ 43.

The Commission should not adopt any blanket regulatory limitations on inclusion of these costs. Instead, as the Notice proposes, at most it should monitor industry practices and address this issue at a later date, if necessary.

III. THE COMMISSION SHOULD NOT ADOPT AN INDUSTRY-WIDE RATE OF RETURN

Whether the "net effect" of a rate is unreasonable hinges on the allowable rate of return.[37] The rate of return must take into account the cost of debt and preferred stock and an analysis of the cost of equity. The Supreme Court has instructed that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital."[38] In its approach to this issue, the Notice fails to heed this standard. It not only proposes to shrink the allowable rate base, but also to adopt an

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[37] Duquesne Light Co. v. Barasch, 488 U.S. 299, 310 (1989) ("[W]hether a particular rate is 'unjust' or 'unreasonable' will depend to some extent on what is a fair rate of return given the risks under a particular rate-setting system, and on the amount of capital upon which the investors are entitled to earn that return. At the margins, the questions have constitutional overtones.")

[38] Hope, 320 U.S. at 602. See also Bluefield Water Works & Imp. Co. v. Pub. Service Comm. of West Virginia, 262 U.S. 679, 692-93 (1923) ("A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.")